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ACCOUNTING FOR ECONOMY ACT ORDERS BY THE NAVY
WORKING CAPITAL FUND ORGANIZATIONS

Report No. D-2001-160

July 18, 2001

Office of the Inspector General
Department of Defense

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Acronyms

ASN (FM&C)	Assistant Secretary of the Navy (Financial Management and Comptroller)
SPAWAR	Space and Warfare Systems Command
WCF	Working Capital Fund



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
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ARLINGTON, VIRGINIA 22202-4704

July 18, 2001

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)
ASSISTANT SECRETARY OF THE NAVY
(FINANCIAL MANAGEMENT AND
COMPTROLLER)

SUBJECT: Audit Report on Accounting for Economy Act Orders by Navy Working
Capital Fund Organizations (Report No. D-2001-160)

We are providing this report for review and comment.

We performed the audit in response to the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994. This is the first in a series of audits pertaining to DoD accounts payable. We considered a preliminary response from the Assistant Secretary of the Navy (Financial Management and Comptroller) to the draft of this report when preparing the final report. However, final comments were not received.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. Comments from the Under Secretary of Defense (Comptroller) on Recommendation 1. were not received. A preliminary and informal response from the Assistant Secretary of the Navy (Financial Management and Comptroller) on the finding and Recommendation 2. was considered, resulting in a revision to the finding and Recommendations 1. and 2. Therefore, we request that the Under Secretary of Defense (Comptroller) and Assistant Secretary of the Navy (Financial Management and Comptroller) provide comments on the reported material weakness and revised Recommendations 1. and 2. by August 17, 2001.

We appreciate the courtesies extended to the audit staff. For additional information on this report, please contact Mr. Brian Flynn at (703) 604-9489 (DSN 664-9489) (blynn@dodig.osd.mil) or Mr. Byron B. Harbert at (303) 676-7405 (DSN 926-7405) (bharbert@dodig.osd.mil). See Appendix B for the report distribution. The audit team members are listed on the inside of the back cover.

A handwritten signature in black ink, reading "Thomas F. Gimble".

Thomas F. Gimble
Acting
Deputy Assistant Inspector General
for Auditing

Office of the Inspector General, DoD

Report No. D-2001-160

(Project No. D1999FD-0067)

July 18, 2001

Accounting for Economy Act Orders by the Navy Working Capital Fund Organizations

Executive Summary

Introduction. This audit was performed in response to the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994. This is the first report from our audit of DoD accounts payable and addresses an Assistant Secretary of the Navy (Financial Management and Comptroller) policy that affects the Navy working capital fund accounting and reporting requirements for all of its organizations. Accounts payable is used to record amounts owed for goods and services received but for which payment has not been made. As of September 30, 2000, the Navy working capital fund reported accounts payable of \$986 million. That amount did not include accounts payable arising from Economy Act orders placed with the Navy working capital fund using directly cited \$1.15 billion of customer funds which should have been recorded and accounted for on a reimbursable basis. The Economy Act, as codified in section 1535, title 31, United States Code, provides a Federal agency or major organizational unit with the authority to place orders for goods or services with another Federal agency or major organizational unit. Orders placed using directly cited funds are posted, accounted for, and disclosed in the financial statements of the customer.

Objectives. Our objective was to determine whether the accounts payable line of the DoD Agency-Wide financial statements was prepared in accordance with Office of Management and Budget Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1998, as amended January 25, 1999. We also examined internal controls and compliance with applicable laws and regulations. Specifically, we reviewed DoD agency and Military Department compliance with laws and regulations related to the working capital fund, acceptance of Economy Act orders, and accounting and reporting requirements. We also reviewed the management control program as it related to Navy working capital fund acceptance of Economy Act orders.

Results. During FY 2000, the Space and Warfare Systems Command Research, Development, Test and Evaluation Centers and the Naval Air Warfare Center, Weapons Division (working capital fund activities), accepted Economy Act orders from customers that directly cited their appropriations instead of placing the orders on a

reimbursable basis. That practice was not observed in our audit of working capital fund activities in the Army and the Air Force. According to the Office of Accounting Policy, Office of the Under Secretary of Defense (Comptroller), the Navy practice was not in accordance with the intent of the DoD Financial Management Regulation, volume 11A, Reimbursable Operations, Policy and Procedures, and volume 11B, Reimbursable Operations, Policy and Procedures – Working Capital Funds. As a result, Economy Act orders using directly cited funds were not accounted for and reported in the Navy working capital fund financial statements creating a \$1.15 billion material misstatement of the program cost and work performed by the Navy working capital fund organizations. See the Finding section for details.

Summary of Recommendations. We recommend that the Under Secretary of Defense (Comptroller) revise the DoD Financial Management Regulation, Volume 11A, Reimbursable Operations, Policy and Procedures, and Volume 11B, Reimbursable Operations, Policy and Procedures – Working Capital Funds accounting policies to require that working capital fund transactions be fairly and fully disclosed in the financial statements. In addition, we recommend that the Assistant Secretary of the Navy (Financial Management and Comptroller) issue procedures for accounting for all Navy working capital fund transactions that would ensure fair and full disclosure of the operational cost of the working capital fund.

Management Comments. We provided a draft of this report to management on March 29, 2001. No written response was received from the Under Secretary of Defense (Comptroller) or the Assistant Secretary of the Navy (Financial Management and Comptroller). Therefore, we request that the Under Secretary of Defense (Comptroller) and the Assistant Secretary of the Navy (Financial Management and Comptroller) provide comments by August 17, 2001.

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Background

The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, requires audits by the Inspectors General of financial statements prepared. This is the first report from our audit of DoD accounts payable and this report addresses an Assistant Secretary of the Navy (Financial Management and Comptroller) policy that affects the Navy working capital fund accounting and reporting requirements for all of its organizations.

In conducting our audit, we used the Federal Financial Management System methodology developed by the General Accounting Office. This system incorporates a review of accounts payable transactions by cycle, functions, processes, and systems that result in the posting of the accounts payable in the United States Standard General Ledger. As of September 30, 2000, the Navy working capital fund reported accounts payable in the amount of \$986 million. That sum did not include accounts payable resulting from Economy Act orders placed with the Navy working capital funds using directly cited funds. The Economy Act, as codified in section 1535, title 31, United States Code (31 U.S.C. 1535), grants the authority to a Federal agency or major organizational unit to place orders for goods or services with another Federal agency or major organizational unit. Orders placed using directly cited funds are posted, accounted for, and disclosed in the financial statements of the customer.

Objectives

Our objective was to determine whether the accounts payable line of the DoD Agency-Wide financial statements was prepared in accordance with Office of Management and Budget Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1998, as amended January 25, 1999. We also examined internal controls and management compliance with laws and regulations. Specifically, we reviewed DoD agency and Military Department compliance with applicable laws and regulations related to the working capital fund (WCF), acceptance of Economy Act orders, and the accounting and reporting requirements applicable to the WCF. We also reviewed the management control program as it related to Navy WCF acceptance of Economy Act orders.

Acceptance of Economy Act Orders

During FY 2000, the Space and Warfare Systems Command (SPAWAR) Research, Development, Test and Evaluation Centers and the Naval Air Warfare Center, Weapons Division, accepted Economy Act orders totaling \$1.15 billion from customers that directly cited their appropriations instead of accepting the orders on a reimbursable basis. That practice was not observed in our audit work in the WCF of the Army and the Air Force. The two Navy organizations accepted the \$1.15 billion in orders because the Assistant Secretary of the Navy (Financial Management and Comptroller) (ASN [FM&C]) directed Navy WCF organizations to accept Economy Act orders for goods or services that included directly cited funds of the customer. According to the Office of Accounting Policy, Office of the Under Secretary of Defense (Comptroller), the Navy practice was not in accordance with the intent of section 2208, title 10, United States Code (10 U.S.C. 2208) and the DoD Financial Management Regulation, volume 11A, Reimbursable Operations, Policy and Procedures, and volume 11B, Reimbursable Operations, Policy and Procedures – Working Capital Funds. As a result, Economy Act orders using directly cited funds were not accounted for and reported in the Navy WCF financial statements. That created a \$1.15 billion material misstatement of the program cost and work performed by the Navy WCF organizations.

Overall Statutes and DoD Financial Management Policies

The Navy WCF accounting policy for accepting Economy Act orders using directly cited funds is not consistent with the WCF statute and DoD Financial Management Regulations. However, ASN (FM&C) personnel stated that the statutes and DoD Financial Management Regulation were unclear and did not specifically prohibit the use of directly cited funds for Economy Act orders. The result of financing an order by using directly cited funds is that the WCF is not directly reimbursed the full cost of supplies and industrial-type and commercial-type services rendered to the customer. Thus, the transactions are not entered and managed in the accounting records of the servicing WCF.

Working Capital Funds

Section 2208, title 10, United States Code, authorizes the Secretary of Defense to establish working capital funds to control and account more effectively for the cost of programs and work performed within DoD. According to 10 U.S.C. 2208, WCF supply management and industrial-type and commercial-type service activities are required to satisfy reporting requirements by fully disclosing the full cost of operations. Full accounting occurs when the WCF initially pays the cost of operations, including services and work performed. The customer subsequently reimburses the WCF using available appropriations. In addition, the 10 U.S.C 2208 states that funds and activities managed through the WCF must be separately accounted for, reported, and audited.

Economy Act Orders

Section 1535, title 31, United States Code, codifies the Economy Act which authorizes a Federal agency or major organizational unit to place orders for goods or services with another Federal agency or unit. The supplying agency or organization can either directly provide the goods or services or acquire them by contract. The order placed and accepted by the supplying agency or organization constitutes an obligation against the appropriation of the ordering agency or unit. When the goods or services are received, the requesting organization is required to make prompt payment to the supplying agency or organization, unless payment was made in advance. Section 1535, title 31, United States Code, does not stipulate that Economy Act orders must be made strictly on a reimbursable basis.

DoD Financial Management Regulation

DoD policies and procedures for reimbursable operations and Economy Act orders are in DoD Regulation 7000.14-R, DoD Financial Management Regulation, volume 11A, "Reimbursable Operations, Policy and Procedures," December 1999. Chapter 3, "Economy Act Orders," April 2000 states that the requesting agency must obligate the entire amount of the order once the order is accepted by the supplying agency. Economy Act orders may be accepted and performed by either appropriated fund or WCF organizations. However, if the order is placed with and accepted by a WCF organization, reimbursable costs are to be determined in accordance with volume 11B of the DoD Financial Management Regulation. Volume 11B, "Reimbursable Operations, Policy and Procedures – Working Capital Fund," December 1994, Chapter 52, "Budgetary Resources," defines Economy Act orders as requisitions and orders for goods or services to be furnished on a reimbursable basis. The DoD Financial Management Regulation does not require a WCF to accept Economy Act orders on a strictly reimbursable basis. However, the DoD Financial Management Regulation does not provide accounting policy on how the WCF should recapture all costs that would ensure fair and full disclosure of the cost of operations in the financial statements.

Reimbursement

According to 10 U.S.C 2208, WCF organizations expend their own funds to pay for ordered goods and services, and they should be subsequently reimbursed for those costs by the appropriation cited in the Economy Act order. The Army and the Air Force WCF organizations follow that practice. In our opinion, that practice is more efficient and effective method to account for and report the results of WCF operations separately from appropriated fund organizations. Separate accounting is accomplished when the WCF organization records and posts transactions in the WCF general ledger.

Navy Interpretation of Accepting Economy Act Orders

Personnel from the Civilian Resources and Business Affairs Division and Budget Policy and Procedures Division of the ASN (FM&C) stated that 31 U.S.C 1535, 10 U.S.C 2208, and the DoD Financial Management Regulation were unclear and did not prohibit WCF organizations from accepting Economy Act orders using directly cited funds. The Navy is correct on that point. However, the reporting requirements of 10 U.S.C 2208 were not met. The acceptance of Economy Act orders using directly cited funds effectively masks the activities of the fund when the cost of work performed and paid with directly cited funds is not accounted for and recorded in the WCF financial records. Thus, the Navy practice circumvents a full and accurate reporting of its WCF operations. Such full and accurate reporting of WCF operations is most efficiently and effectively accomplished when Economy Act orders are filled on a reimbursable basis and the WCF records all transactions in its accounting systems. Although we believe WCF activities should perform all work on a strictly reimbursable basis, the current statutes and the DoD Financial Management Regulation do not prohibit acceptance of Economy Act orders using directly cited funds. However, the WCF must fully satisfy the reporting requirements of 10 U.S.C. 2208.

Summary

The SPAWAR and Naval Air Warfare Center organizations reported more than \$1.15 billion in Economy Act orders containing multi-year directly cited funds in FY 2000. The practice of accepting Economy Act orders with directly cited funds was not limited to those two organizations and existed at other Navy WCF organizations as well. Personnel in the Office of the ASN FM&C believed that the use of directly cited funds for Economy Act orders to WCF organizations was not prohibited by the statutes and the DoD Financial Management Regulation. We believe the intent of the statutes and the DoD Financial Management Regulation could best be met if Economy Act orders were accepted on a reimbursable basis. Under that practice, all Economy Act orders and costs related to the WCF would be accounted for and reported in the WCF financial statements. Unless the Office of the Under Secretary of Defense (Comptroller) and ASN FM&C implement policies and procedures to account for all WCF transactions, the Navy practice will continue to materially misstate assets, liabilities, revenues, and expenses.

Recommendations

Revised Finding and Revised Recommendations. As a result of a preliminary response from the Navy, we revised the draft finding to exclude a discussion of carryover and clarified our discussion on the statutes and regulations pertaining to Economy Act orders and the working capital fund. Accordingly, we also revised Recommendations 1. and 2.

1. We recommend that the Under Secretary of Defense (Comptroller) revise the DoD Financial Management Regulation, volume 11A, Reimbursable Operations, Policy and Procedures, and volume 11B, Reimbursable Operations, Policy and Procedures – Working Capital Funds to provide accounting policy which would require the fair and full disclosure of all transactions in the working capital fund financial statements.
2. We recommend that the Assistant Secretary of the Navy (Financial Management and Comptroller) issue procedures that would account for and report all transactions related to its supply and industrial-fund and commercial-type activities in the working capital fund financial statements.

Management Comments Required

The Under Secretary of Defense (Comptroller) and Assistant Secretary of the Navy (Financial Management and Comptroller) did not comment on the draft of this report. We request that the Under Secretary of Defense (Comptroller) and Assistant Secretary of the Navy (Financial Management and Comptroller) provide comments on the final report.

Appendix A. Audit Process

Scope

Work Performed. We reviewed SPAWAR and the Naval Air Weapons Center Research, Development, Test and Evaluation WCF organizations, and related funding documents for goods and services received by the organizations. At each location visited, we judgmentally sampled 10 FY 1999 contracting actions, valued at \$25,000 or more, and examined the contract terms and clauses related to the payments made to contractors for goods or services provided by the WCF to its customers. In FY 2000, SPAWAR Research, Development, Test and Evaluation Centers at Charleston, South Carolina, and San Diego, California, accepted new orders from its customers totaling \$2,420,794,000. The Centers reported reimbursable orders of \$1,533,299,000 and orders containing directly cited funds of \$887,495,000. In FY 2000, the Naval Air Weapons Center's Research, Development, Test and Evaluation organizations at China Lake, California, and Point Mugu, California, accepted new orders totaling \$1,067,450,000. The Centers reported \$804,228,000 in reimbursable orders and accepted \$263,222,000 of orders with directly cited funds. We discussed those contracts and funding documents with SPAWAR, Naval Air Weapons Center, and personnel in the Office of ASN (FM&C) to determine the policies and procedures related to those contracts and funding documents. Based on their explanations, we reviewed the applicable statutes, DoD Financial Management Regulation, and Navy policies and procedures.

DoD-Wide Corporate Level Government Performance and Results Act Coverage. In response to the Government Performance and Results Act, the Secretary of Defense annually establishes DoD-wide corporate-level goals, subordinate performance goals, and performance measures. This report pertains to achievement of the following goal, subordinate performance goal, and performance measures:

- **FY 2001 Corporate Level Goal 2:** Prepare now for an uncertain future by pursuing a focused modernization effort that maintains U.S. qualitative superiority in key warfighting capabilities. Transform the force by exploiting the Revolution in Military affairs, and reengineer the Department to achieve a 21st century infrastructure. **(01-DoD-2)**
- **FY 2001 Subordinate Performance Goal 2.3:** Streamline the DoD infrastructure by redesigning the Department's support structure and pursuing business practice reforms. **(01-DoD-2.3)**
- **FY 2001 Subordinate Performance Goal 2.5:** Improve DoD financial and information management. **(01-DoD-2.5)**
- **FY 2001 Performance Measure 2.3.8:** Defense Working Capital Fund (DWCF) Net Operating Results **(01-DoD-2.3.8)**

-
- **FY 2001 Performance Measure 2.5.2:** Achieve unqualified opinions on financial statements. **(01-DoD-2.5.2)**

DoD Functional Area Reform Goals. Most major DoD functional areas have also established performance improvement reform objectives and goals. This report pertains to achievement of the following functional area objectives and goals.

- **Acquisition Management Area. Objective:** Internal reinvention. **Goal:** Define requirements and establish and implement a cost accounting system that provides routine visibility through activity based costing and management. **(ACQ3-2)**
- **Financial Management Area. Objective:** Reengineer Business Practices. **Goal:** Provide policies and procedures that are clear and simple, and which ensure compliance with existing laws and regulations. **(FM 2-5)**

General Accounting Office High-Risk Area. The General Accounting Office has identified several high-risk areas in the DoD. This report provides coverage of the Defense Financial Management high-risk area.

Methodology

Use of Computer-Processed Data. Computer-processed data were not used in this audit.

Audit Type, Dates, and Standards. We performed this financial-related audit from October 1999 through March 2001 in accordance with audit standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD. We did our work in accordance with generally accepted Government auditing standards except that we were unable to obtain an opinion on our system of quality control. The most recent external quality control review was withdrawn on March 15, 2001, and we will undergo a new review.

Contacts During the Audit. We visited or contacted individuals and organizations within the DoD. Further details are available on request.

Management Control Program Review

DoD Directive 5010.38, "Management Control (MC) Program," August 26, 1996, and DoD Instruction 5010.40, "Management Control (MC) Program Procedures, August 28, 1996, require DoD organizations to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of the controls.

Scope of the Review of the Management Control Program. We identified material control weaknesses for the Navy WCF as defined by DoD

Instruction 5010.40. Navy WCF financial statements were materially misstated by \$1.15 billion when Navy WCF organizations accepted Economy Act orders using directly cited funds. The Navy did not identify the material weakness because it resulted from Navy policy. Recommendations 1. and 2., if implemented, will ensure that Navy working capital fund organizations will fairly and fully all transactions in the financial statements, and thus, will correct the material weakness.

Prior Coverage

The General Accounting Office and the Inspector General, DoD, have conducted multiple reviews related to financial statement issues. General Accounting Office reports can be accessed on the Internet at <http://www.gao.gov>. Inspector General, DoD, reports can be accessed on the Internet at <http://www.dodig.osd.mil/audit/reports>.

Appendix B. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)
Deputy Comptroller (Program/Budget)
Deputy Chief Financial Officer

Department of the Army

Auditor General, Department of the Army

Department of the Navy

Assistant Secretary of the Navy (Manpower and Reserve Affairs)
Naval Inspector General
Auditor General, Department of the Navy

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Department of the Air Force

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Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Committee on Armed Services
House Committee on Governmental Affairs
House Subcommittee on Government Efficiency, Financial Management, and Intergovernmental Relations, Committee on Government Reform
House Subcommittee on National Security, Veterans Affairs, and International Relations, Committee on Government Reform
House Subcommittee on Technology and Procurement Policy, Committee on Government Reform

Audit Team Members

The Finance and Accounting Directorate, Office of the Assistant Inspector General for Auditing, DoD, prepared this report. Personnel of the Office of the Inspector General, DoD, who contributed to the report are listed below.

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